6 Steps That Set Your Project Up For Financing Success

PENCILING MULTIFAMILY DEALS IN AN UNCERTAIN MARKET

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Introduction

MARKET UNCERTAINTY

It's a vicious cycle.

- Demographic trends and aging housing stock result in rising rents.
- Rising rents directly contribute to higher inflation. Rising rents also leads to more development, leading to higher construction pricing and therefore higher inflation.
- Higher inflation leads the Fed to raise interest rates.
- Higher interest rates result in higher interest reserve requirements on construction loans. Lenders then get concerned about default risk on existing construction loans.
- Buyers expect higher cap rates to compensate for higher interest rates.
- Sellers take a while to accept higher cap rates in the market.
- With fewer deals trading, velocity of capital slows down.
- Lenders underwrite at a lower LTC.
- Now, developers have to find more equity.
- Equity partners have to put more cash into each deal so they are able to fund fewer projects. There is a flight to sponsors with strong track records and strong financial management practices.

The bright spot is that while rent assumptions have to be more conservative, they are still primarily driven by demographic trends and aging housing stock more than economic trends. And with more checks on inflation and few deals, construction pricing stabilizes if not falls.

There is so much that real estate developers can't control; however, the best real estate developers focus on what they can control—and get creative when the going gets tough.

SO WHAT CAN MULTIFAMILY DEVELOPERS DO TO GET DEALS TO PENCIL IN THIS ENVIRONMENT?

1. Control construction costs
2. Get the best terms from lenders
3. Lower interest reserves
4. Control soft costs
5. Control contingency
6. Fill the capital stack with creative funding sources

1

CONTROL CONSTRUCTION COSTS

The market has shifted from a general contractor's market to a developer's market. In this highly competitive construction market, developers basically have to accept whatever pricing comes in. That being said, in a market with fewer construction starts, developers have more room for negotiation.

HOW TO LOWER HARD COST PRICING

1. Get a third-party cost review.

2. Ask for a list of key subcontractors and materials providers. Verify financial health and negotiate discounts for providing deposits, reduced retainage, or faster payment terms.

3. Bring in the architect to value engineer costly parts of the project.

4. Ask the general contractor for discounts for more frequent draws or faster payment terms.

5. Get quotes from multiple general contractors. If you are having trouble getting quotes, ask for support from civil engineers or architects you have good relationships with. Consider offering attractive terms like more frequent draws.

6. Work with a project team (general contractor, architect, civil engineer) experienced in the jurisdiction of the project.

7. Reuse floor plates and floor plans across projects in different markets.

2

GET THE BEST TERMS FROM LENDERS

The number one quality lenders look for is track record, number two is longevity of relationship with the lender, and number three is the quality of the deal.

Unfortunately, developers can't magically get a longer or more successful track record, but there are a few other decisions developers can make to lower their risk profile and secure the best available terms for a construction loan.

HOW TO GET THE BEST TERMS FROM A LENDER

1. If you have in-house construction management, consider using a third-party GC.

2. Shop multiple lenders and multiple types of lenders (National bank vs regional vs community vs debt funds).

3. If it is a bank, open a deposit account.

4. Be as transparent as possible with your financial records, especially with banks.

5. Work with a general contractor and equity partner with a long track record.

6. Negotiate development and construction fees (if in-house). Structure fees on milestones or as a percentage of certain line items.

3

LOWER INTEREST RESERVES

Interest reserves are a function of draw schedule and rate assumptions. As a rule, the less conservative a project budget is underwritten, the more conservative interest reserves will be.

Luckily, developers do have some control over some assumptions in the interest reserve calculation.

HOW TO LOWER INTEREST RESERVES

1. Provide a draw schedule to your lender vs having them generate their own.

2. If a lender's draw schedule is more aggressive than yours, work with the general contractor or third-party cost reviewer to put together a draw schedule that more closely aligns with the construction schedule.

3. Ensure timing of retainage is accounted for in the draw schedule. That's ~10% you can push to the end of the construction period.

4. Delay any fees not essential to running your business to the back end of your project. For example, you might shift some of the development fee to an asset management fee that doesn't kick in until construction is complete.

4

CONTROL SOFT COSTS

When it comes to soft cost vendors, you often get what you pay for, so developers shouldn't cut corners. However, developers can keep these costs from ballooning during pre-development.

HOW TO CONTROL SOFT COSTS

1. Start with a good lawyer.

2. Establish spending thresholds for stages of pursuit & pre-development. Require IC or partner approval prior to exceeding these.

3. Track all costs to agreements and closely monitor any out of contract costs.

4. Conduct a monthly internal draw process, even before you take on equity or debt.

5. Work with an architect and civil engineer experienced in the jurisdiction of the project.

6. Preset annual design packages across projects vs. developing a new package for each project.

7. Reuse floor plates and floor plans across projects in different markets.

5

CONTROL CONTINGENCY

Contingency is important for mitigating the risk of the deal and improving the overall efficiency of managing the project. Contingency provides flexibility in decision making and saves development managers from having to get approval for every overrun. There is a good argument for lowering contingency requirements under these market conditions.

Lowering contingency requirements can make a deal pencil, both directly and indirectly through contingency's impact on interest reserve modeling.

HOW TO LOWER A LENDER'S CONTINGENCY REQUIREMENTS

1. Provide confidence the developer and LP can afford budget overruns.

2. Agree to buy out requirements such as 80% buy out before closing the loan or 100% bought out prior to construction start.

3. Provide a third-party cost review or the other lower-cost bids you didn't go with.

4. Work with a lawyer to ensure you have key clauses in the contract with your general contractor. Educate the lender on the value of these clauses.

6

FILL THE CAPITAL STACK WITH CREATIVE FUNDING SOURCES

With the best pricing, best terms, and lowest risk, it can still be tough to source financing when the construction loan is at a 50% LTC. In this capital environment, developers can turn to alternative funding sources to get deals done.

CREATIVE FUNDING OPTIONS FOR MULTIFAMILY DEVELOPMENTS:

1. C-PACE: C-PACE funds are administered by state and local jurisdictions to encourage investments in renewable energy, energy efficiency, or building resiliency. Funds may cover up to 100% of a specified costs (local jurisdiction sets what types of costs qualify). Funds are repaid over 10-20 years in the property tax bill, and can be paid off or assumed upon sale of the property. Funding amounts over $5M is common. Requires lender consent.

2. Opportunity Funds: May offer more competitive terms for projects in opportunity zones.

3. EB-5 investment: Investment from foreign nationals seeking permanent residency in the United States. Typically sourced through a "Regional Center" and structured as pref equity with 7-8% return. Additional incentives for rural projects. Project must create at least 10 jobs. Typically repaid in 5-7 years.

4. Preferred equity: Equity that sits between debt and sponsor equity in the cap stack. Costs more than debt, but less than LP equity. LP will need to agree to the structure as it changes risk profile.

CREATIVE FUNDING OPTIONS FOR MULTIFAMILY DEVELOPMENTS CONTINUED:

5. Mezz debt: Debt that sits between construction loan and equity. Costs more than construction loan, but less than equity.

6. HUD 221(d)4: Specify 20-40% of units as income-restricted and potentially become eligible for an assumable, non-recourse construction to perm (3+40 year) loan. The process takes 6-12 months and significant paperwork. .

7. 4% LIHTC: Hire a certified historically underserved business as a consultant if it's your first time with this process, but you may be able to switch your market rate deal and to affordable rates to qualify for a 50% bond and a tax credit that nets ~25% equity on your deal. The remaining cap stack requires 20-30% LTC construction loan and potentially no equity. The process takes 6-9 months and significant paperwork.

8. Public Facility Corporation (PFC): Texas—a high property tax rate state—offers a method for developers to exempt multifamily properties from sales tax on construction materials and all property taxes. Developers can transfer the land into a PFC owned by a local public housing authority, county, or city and lease back the land to achieve these benefits. 50% of the units in projects sponsored by public housing authorities' PFCs must be reserved for occupancy by households earning less than 80% of the area median family income. The process is relatively quick and requires much less documentation and reporting than other public funding options on this list.

Summary

SO HOW DO MULTIFAMILY DEVELOPERS GET DEALS TO PENCIL IN A MARKET WITH SO MUCH UNCERTAINTY?

Development leaders and managers need to dig in with their capital markets team to identify the best financing options available to the firm and focus on finding deals that fit the investment profile.

CONTROL WHAT YOU CAN AND GET CREATIVE

1. Control construction costs
2. Get the best terms from lenders
3. Lower interest reserves
4. Control soft costs
5. Control contingency
6. Fill the capital stack with creative funding sources

DEVELOPERS HAVE MORE OPTIONS IN THIS MARKET THAN IT SEEMS

Willing new developments to happen in a down market is nothing short of challenging. Some developers will choose to sit on the sidelines and others will run straight at the challenge.

Prompt proactive conversations with potential equity partners, general contractors, and architects about your approach to projects in this environment. Collaboration with these groups can make or break your deals. The more deals you close, the more business for everyone…and that's something everyone can enjoy.

LEARN HOW RABBET HELPS DEVELOPERS MANAGE, TRACK, AND ORGANIZE THEIR CONSTRUCTION FINANCES WITH EASE AND EFFICIENCY.

SCHEDULE A MEETING

ABOUT RABBET

Rabbet is transforming the construction finance industry with tailored solutions that provide the complete picture of real estate construction portfolios. Designed for real-time workflows and comprehensive insights, Rabbet enables real estate developers, lenders, investors and related service providers to lower operational costs, make more informed decisions, and earn trust with other financial stakeholders. Founded in Austin, TX in 2017, Rabbet has improved visibility and efficiency for over $41B in construction capital.

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